

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:SB:3:FTL:POSTF-148574-01  
WLSaka

date:

to: Gayle Kapouch  
Appeals Team Manager, SBSE Area 5 - FLL  
Att'n: Darcy Parker, Appeals Officer

from: JOHN T. LORTIE  
Senior Attorney (SBSE)

subject: Advisory Opinion - [REDACTED]  
Form 1065/ [REDACTED], [REDACTED], [REDACTED]

ISSUES:

1. Is the taxpayer's method of accounting for case costs (cash basis - deductible when paid) a proper method for cases involving class action suits engaged on a contingency basis?

2. Are there any state statutes or state Bar Association regulations concerning the advancement of case costs for class action litigation?

CONCLUSION:

1. Although there is no case law directly on point, we do not believe the cash method is a proper accounting method for case cost involving class action suits engaged on a contingency basis.

2. There were no state statutes or state Bar Association regulations found which specifically address the advancement of case costs for class action litigation.

FACTS

The taxpayer is a law firm conducting business in Florida.

[REDACTED]  
[REDACTED]. The law firm is on the cash method of accounting. Beginning in [REDACTED], the firm deducted case costs incurred for each case in the year they were paid. Case costs included computer research, courier charges, court reporter fees, deposition transcripts, expert witness fees, witness fees, filing fees,

parking, photocopying, postage, process service, storage, etc. According to the taxpayer's accounting records, each case is charged with specific costs and those costs are accumulated during the year. In [REDACTED], the total case costs, net of any reimbursements received, were deducted on the return. However, in [REDACTED] and [REDACTED], the total case costs paid were deducted and any reimbursements received were subsequently included in gross income.

The Revenue Agent believes this method of deducting expenses on the cash basis has distorted the taxpayer's income because the receipt of any attorney fee income and cost reimbursements are only made at the conclusion of a case, which is often several years after the payment of the expenses.

According to the retainer agreement provided, some type of screening process is performed by the taxpayer prior to the filing of a claim. Assuming the law firm/taxpayer decides to accept a case, it is done on a contingency basis. The firm will advance all case cost and litigation costs necessary "for the proper prosecution of this case." These costs will be recovered upon the "successful conclusion" of the claim. After these costs are recovered, taxpayer will "seek a reasonable fee as determined by the court." The Revenue Agent has taken the position that the case costs should be treated as loans because the taxpayer recovers these costs prior to receiving its fee. You have now sought our advice regarding this issue.

#### DISCUSSION:

Section 162 of the Internal Revenue Code allows for a taxpayer to deduct ordinary and necessary expenses incurred during the taxable year in carrying on any trade or business. In Silverton v. Commissioner, 36 T.C.M. 817 (1977), the court held litigation costs and case preparations did not constitute ordinary and necessary expenses and therefore, were not deductible. In that case, for a nominal retainer, petitioner would provide members of various church groups and labor unions with legal advice. Petitioner usually worked with personal injury and workman's compensation cases. If it was determined that each claim had sufficient merit, the case was taken on a contingency basis. The retainer agreement supplied by petitioner to each client stated that "case-preparation and litigation costs" would be advanced by the petitioner's law firm and the law firm would only recover these costs after "successful prosecution or settlement of the claim." Upon a recovery, after all advanced fees have been recovered, the firm would compute its fees as a percentage of the net proceeds of the settlement or judgement.

The issue raised in Silverton is whether the costs advanced by petitioner on behalf of the clients are ordinary and necessary business expenses, and therefore, deductible under I.R.C. §162, or whether the advanced costs are considered loans which would not be deductible under §162.

In Silverton, the court found that petitioner's firm only pursued those clients' claim which were considered meritorious. Thus, it increased petitioner's likelihood of recovering costs. The court reasoned that the costs should be considered loans, not ordinary and necessary expenses, since petitioner believed the advanced costs could be recovered, and therefore, should not be deductible.

In Pelton & Gunther v. Commissioner, 78 T.C.M. 578 (1999), the court similarly held that the costs advanced in litigation by a law firm should be treated as loans and not deductible under §162 since the law firm knew it would be reimbursed for all advanced costs. In Pelton, petitioner's legal specialty was personal injury cases. About 90% of all petitioner's services were performed at the request of the California State Automobile Association (CSAA). Each time petitioner was asked to perform legal services by CSAA, CSAA would pay petitioner \$400.00. Petitioner would then pay all litigation costs with regards to each request. Most of the time, the litigation costs exceeded \$400.00.

After the cases were closed, petitioner would bill CSAA for services performed. Petitioner's bills were stated at an hourly rate and not on a contingency basis. Petitioner understood it would be reimbursed for the balance of all advanced costs minus the \$400.00 retainer.

The court in Pelton held that petitioner knew it was to be reimbursed on an dollar-for-dollar basis. The advanced costs were not considered a burden on petitioner. The advanced costs should be considered loans and therefore, not deductible.

In Silverton and Pelton, each court held the payments of these expenses under net fee arrangements are not ordinary and necessary business expenses under IRC §162. These expenses are considered loans to the clients for which the law firm is entitled to reimbursement out of any recovery. In the event there is no recovery or reimbursements paid by the client, the court in Pelton has stated the law firm may claim a bad debt deduction at the time the debt is determined worthless, as required by Reg. 1.166-2(b).

Our case is similar to Pelton in that the taxpayer reasonably believes to recover all advanced cost associated with each claim. Our taxpayer performs an "investigation" prior to filing any type of claim. Since, the taxpayer believes it will recover all advanced costs, these advanced costs should be treated as a loan to the client.

In our case, the issue is whether case costs involving class action suits engaged on a contingency basis should be treated any differently than costs advanced in an individual client's case. Although there is no case law directly on point with this issue, we do not believe the cash method is a proper accounting method for case cost involving class action suits engaged on a contingency basis.

The taxpayer argues there are numerous plaintiffs in a class action suit and sometimes more than one law firm handling the case. The taxpayer contends where a suit is designated a class suit, the court has the jurisdiction to award fees and reimbursements of costs, leaving no legal obligation of the "named plaintiff" to pay the legal expenses.

In support of its position, the taxpayer cites Alleghany Corporation v. Commissioner, 28 T.C. 298 (1957), and The Electric Tachometer Corporation v. Commissioner, 37 T.C. 158 (1961). The Alleghany case concerns a corporation being allowed to deduct (primarily) legal expenses for protecting its investment in a corporation undergoing a bankruptcy reorganization. The attorneys agreed to make a claim for reimbursement of any fees the corporation paid to them, from the reorganization proceedings. The court held the corporation could deduct such legal expenses, despite the possibility of reimbursement at some future date.

Our case differs from Alleghany because in that case, petitioners were protecting their ownership in stock. It was necessary for petitioners to incur legal expenses in order to protect its investment in stock. In our case, there is no prior investment. When the taxpayer takes on a client it is with the understanding that all case costs will be reimbursed. Therefore, the case costs should not be deductible under §162.

In the Electric Tachometer case, an accrual basis corporation was allowed to deduct the moving expenses incurred to move machinery and equipment despite their later filing a claim for reimbursement from the Commonwealth of Pennsylvania. The court held that an existence of the possibility that at a future date the taxpayer might receive a reimbursement, was not sufficient to disallow an otherwise allowable deduction.

In Electric Tachometer, petitioner was permitted to deduct the moving expenses because the expenses were ordinary and necessary expenses. Our case differs because here the case costs are reimbursable and therefore should be considered as loans.

In summary, we do not believe the cash method is a proper accounting method for case cost involving class action suits engaged on a contingency basis. Therefore, the taxpayer may not deduct cases costs as they are incurred in class action suits taken on a contingency fee basis.

THIS WRITING MAY CONTAIN PRIVILEGED INFORMATION. ANY UNAUTHORIZED DISCLOSURE OF THIS WRITING MAY HAVE AN ADVERSE EFFECT ON PRIVILEGES, SUCH AS ATTORNEY CLIENT PRIVILEGE. IF DISCLOSURE BECOMES NECESSARY, PLEASE CONTACT THIS OFFICE FOR OUR VIEWS.

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JOHN T. LORTIE  
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NOTED:

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KENNETH A. HOCHMAN  
Associate Area Counsel (SBSE)